State of California

The Resources Agency

Memorandum

December 10, 2001

To Honorable Mary D. Nichols
Secretary for Resources
The Resources Agency
1416 Ninth Street, Room 1311
Sacramento, California 95814

: **Department of Water Resources**

Subject Department of Water Resources' Response to the State Auditor's Draft Report

This memo summarizes the Department of Water Resources' principal concerns with the Bureau of State Audit's draft report "California Energy Markets: Pressures Have Eased, but Cost Risks Remain," December 2001. Attached to this memo are DWR's more detailed comments on the Auditor's report. The Auditor's report assesses the performance of DWR in implementing the statutory mandates of Division 27 that was added to the Water Code by the Legislature in AB 1X. AB 1X charged DWR with the responsibility of purchasing the net short energy requirements of the customers of the State's financially insolvent investor-owned electric utilities in California.

Division 27 to the Water Code set forth in clear and unambiguous terms the state's urgent need for *"reliable and reasonably price energy"*. It was the Legislature's direction to DWR to respond *"adequately and expeditiously"* in undertaking and administering this critical responsibility. The urgency of the Legislature's directive was in response to their finding that the State had suffered a *"rapid, unforeseen shortage of electric power and energy" and "substantial increases in wholesale energy costs and retail energy rates"*, and that failing to respond both *"adequately and expeditiously"* would mean *"immediate peril to the health, safety, life and property of the inhabitants of the state"*.

The Report Does Not Address the Impact of DWR's Decisions on the Market and Uses the Wrong Standard of Evaluation

It is inevitable, given the benefit of hindsight and additional information, that DWR would want to revisit and revise certain decisions. However, as a matter of both fairness and accuracy, I believe that the Bureau's report fails in its primary purpose. The Report does not assess the success of DWR's decisions in stabilizing prices and restoring system reliability, nor does it evaluate the reasonableness of DWR's decisions within the context of the crisis environment that they were made, the information that was available to DWR at the time, and against the tremendous risks to the State's economy, and health and safety of its citizens in failing to take decisive action. With this balanced view in mind, DWR offers its comments.

DWR embarked on its power purchase program with the following critical objectives:

- **Establish DWR as a creditworthy party quickly by signing long-term contracts.** Establishing DWR as a creditworthy market participant was critical to the success of DWR's power purchase program; *first,* it was necessary to convince enough power sellers to sign agreements to assure the timely acquisition of generation for the summers of 2001 and 2002; *second,* it had a direct impact on reducing the risk premium being charged by generators and marketers; *third*, it was essential to making short-term vendors comfortable with selling to DWR in the spot market; and *fourth*, it was necessary for convincing bond rating agencies that DWR was worthy of an "investment-grade" rating.

Establishing a creditworthy presence in the view of other market participants was especially important to restoring reliability. At the onset of DWR's power purchasing activities, credit concerns were often the stated cause of sellers' unwillingness to sell to California and DWR.

Of course, having investment grade bonds is the linchpin to repaying the State's General Fund over $6 billion that has been spent on short-term energy purchases. AB 1X specifically prohibits the State from issuing debt without an investment-grade rating.

- **Utilize industry standard contracts containing accepted and recognized terms and conditions that would ensure contractor performance.** Use of accepted form contracts was critical for DWR to achieve the market stabilization mandates of AB 1X in the necessary time frame. These contracts provide DWR with commercially reasonable assurances it will receive the power it bargained for at the agreed-upon prices. If the generators fail to deliver power for which they are obligated, the contracts would provide for payment to DWR of substantial financial damages.

- **Secure enough power supply under long-term contracts in quantities that would limit the state's exposure to volatile spot market prices.** DWR began its power purchasing activity spending between $60 million to $100 million per day. The average daily spot market price for energy was in excess of $400/MWh with hourly peak period prices ranging from $300 to over $1,000/MWh. DWR was consistently requesting $500 million from the General Fund with ten days advance notice—the limit established under AB 1X—to meet its cash flow requirements for the purchases. The daily drain on the General Fund had to be reduced if the State was to have the temporary cash it needed to meet the normal requirements of government, while still providing funds sufficient to maintain reliability of the electric grid.

The State's near-term exposure to volatile spot market prices was not DWR's only concern. Projections for the cost of spot market power for the summer peak hours of 2001 were in excess of $300/MWh. Several experts projected prices in excess of $400/MWh throughout the summer of 2001 and 2002. The sooner DWR could secure energy under long-term contracts, the less exposure there was to these volatile spot prices. This threat was real enough to prompt some utilities in the West to sign forward contracts for deliveries of power that were well in excess of the average contract price negotiated by DWR. For example, in a recent complaint filed with the Federal Energy Regulatory Commission (EL02-28), Nevada Power and Sierra Pacific are asking FERC to readjust their forward contracts with Enron for the third quarter of 2002. The price of these contracts ranged from $230/MWh to $290/MWh. DWR's contracts for the same period have an average cost of $124/MWh.

- **Contract with developers of new power plants to provide the revenue certainty they needed to secure financing.** Contracting with developers of new power plants was critical not only to ensuring their timely completion and availability for the coming summer and next, but to also increasing overall generation capacity reserve levels in the State which have been declining steadily for the last 10 years. Adequate reserve levels are needed for both reliability, and for limiting the ability of generator's and marketers to manipulate price thereby reducing price volatility.

Major Achievements of DWR in Implementing AB 1X

DWR believes that history provides an objective and unbiased assessment of its achievements and that the Bureau has ignored the following facts in their assessment of DWR's power purchase program:

- **Spot market prices are now in the range of $25 to $60/MWh when the industry projected prices at five to ten times this level for this period.** For the peak demand periods this represents between an 800 to 1,000 percent decline from spot market prices DWR was seeing as late as May.

- **DWR's daily cost of electricity has declined by 600 percent from the first weeks in January and February.** DWR new spends between $10 and $15 million per day to cover the utility net short energy requirement compared to the $60 to $100 million per day spent earlier in the year. This amount includes the amount paid for contract purchases, spot market purchases, and the cost of capacity reserves.

- **Despite dire predictions that the summer of 2001 would be plagued by several hundred hours of blackouts, there were none.** The last rotating blackout in the State was on May 8. The Independent System Operator declared a Stage 2 emergency–operating reserves less than five percent–for only two days in July.

- **For the summer of 2001, 70 to 80 percent of the utility net short energy requirement was met through long-term and short-term bilateral contracts.** This was a complete reversal of DWR's position in February where DWR was buying over 80 percent of the utility net short energy requirements in the spot market. DWR's contracting effort provided both supply certainty and limited exposure to volatile spot market prices for this past summer.

- **Over 70 percent of the energy contracted for by DWR will come from new power plants.** DWR's long-term contracts allowed developers to secure financing to guarantee the construction of a significant amount of the new generation capacity in the State. These contracts will also provide almost 1,300 MW of new peaking generation capacity that is critical to meeting spikes in demand during hot weather and maintaining minimum reserve levels that are essential to the reliability of the grid.

The above achievements were not even conceivable in the first half of this year. Yet, the Auditor's report dismisses them as irrelevant in their assessment of the performance of DWR. The graphs attached to this memo dramatically illustrate how successful DWR was in meeting its statutory mandate.

DWR recognizes that other factors, outside of DWR's control, have helped to mitigate the crisis that the State faced, principal among them being the voluntary conservation efforts of all Californians. Others have suggested that the State also benefited this past summer from milder than normal temperature conditions, a claim that the California Energy Commission has refuted. The summer of 2001 was not, on balance, a mild summer. In addition, the FERC price cap order of June 19, 2001 is also cited as contributing toward stabilizing the market. This claim ignores the fact that weeks before the FERC order, DWR was already purchasing spot market power at a price that was significantly lower than the FERC price cap and that since the cap was established, prices have continued to trade 50 to 70 percent lower than the FERC price cap, significantly questioning the impact of the cap on prices.

Of course, DWR is grateful for any and all-ancillary contributions to bringing about lower electricity prices and greater supply certainty and reliability. Again, the charge to the Bureau, however, was to assess the success of DWR in achieving the mandate of AB 1X—stable prices and reliability—and the reasonableness of DWR's actions. There is no conceivable scenario in my mind where the low prices and system reliability that we are currently seeing could have occurred without the involvement of DWR.

Challenges Remain to be Addressed

Under no circumstances, however, should the State be lulled into a sense of complacency with respect for the potential for future price and supply disruptions. DWR will continue for the next year to be responsible as the creditworthy backer for real-time energy imbalance costs. Because of a recent FERC order, the ability of DWR to monitor the costs and risk of real-time energy purchases has been severely curtailed.

Until December 14, 2001, DWR will have purchased much of the real-time energy required to balance the grid and ensure reliability through competitive spot markets. To date, DWR purchased real-time energy at the request of the ISO. A November 20, 2001 FERC order now requires that all real-time energy needed to balance the grid must be procured through ISO's real-time imbalance energy market.

The ISO's real-time market has been unreliable, with generators ignoring dispatch instructions, and costly. Under FERC's price cap order, all generators bidding into the ISO real-time market can receive a single market-clearing price that is capped at the cost of what is typically the dirtiest, least efficient power plant in the entire market. Not surprisingly, generators have a tendency to bid their energy into the ISO real-time market at inflated prices. Since the FERC order was issued, the price of imbalance energy procured through the ISO real-time market has increased 100 percent over the cost DWR was paying through competitive spot markets outside of the ISO market.

Furthermore, California ratepayers are currently at risk for several hundreds of millions of dollars in penalties that have been accruing under an ISO-filed FERC tariff. This particular tariff requires scheduling coordinators with ISO to submit a schedule in the day ahead or hour ahead forward markets that is out-of-balance by no more than 5 percent. As an incentive to submit balanced schedules there is a penalty assessed to each scheduling coordinator that fails to meet the criteria. ISO is not currently invoicing or collecting this penalty from scheduling coordinators. For the California Energy Resources Scheduling division of DWR that is scheduling the long-term contracts and forward market spot purchase against the net short requirements of the IOU's this penalty creates a problem for our ability to control costs for the following reasons:

1. It doesn't allow much flexibility to take advantage of lower real time spot prices, since 95% of the load must to be scheduled in the day ahead or hour ahead forward markets.

2. It represents a charge, which DWR may be billed for if and when the ISO is ordered to collect the penalty by the FERC, for actions of IOUs in scheduling load, when DWR has absolutely no control over IOUs' actions.

The Report does not acknowledge this important flaw in the existing market system and FERC tariffs.

Audit Recommendations Reflect Actions Already Taken By DWR

Lastly, I wish to also point out that DWR has already moved forward on implementing many of the recommendations in the Auditor's Report. The actions being taken by DWR were contemplated well before the Auditor's report and included in DWR's original business plan. These actions are described in the enclosed, more detailed review of the Report.

In summary I would just like to add how extremely proud I am of what DWR has accomplished given the magnitude of the task and the limited time and resources at it's disposal. The recent fate of Enron should serve as an example that having unlimited resources at one's disposal does not always ensure success. While others may second guess the decisions made by DWR, I believe that our comments make a clear and compelling case that our decisions were not only reasonable, but were the best that could have been made at the time.

Original signed by

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Director
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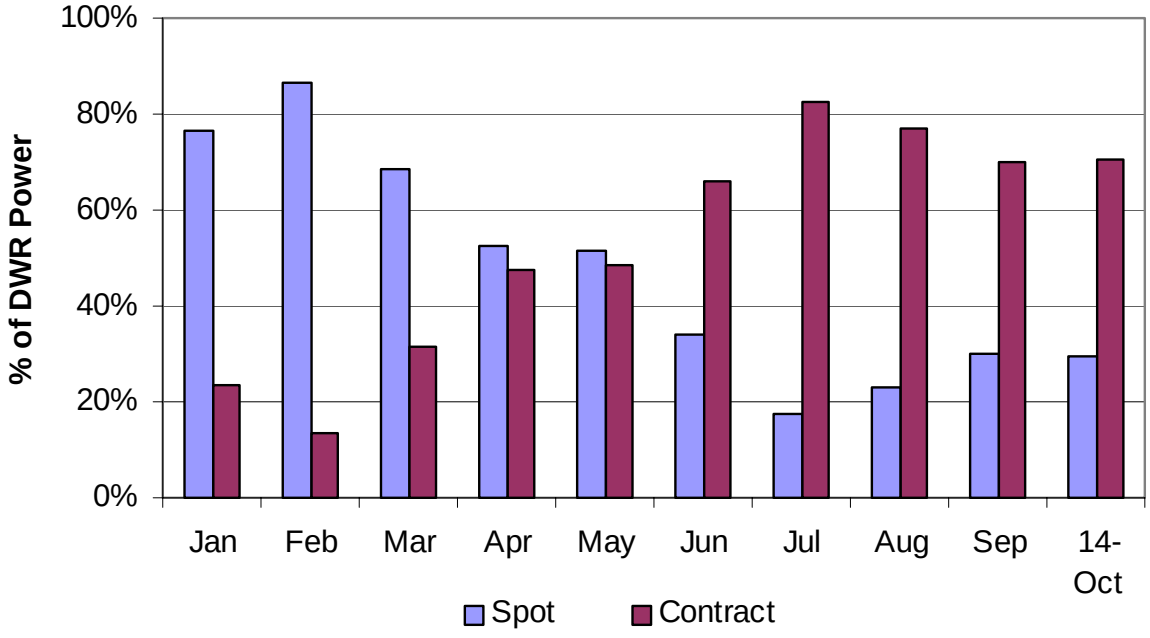
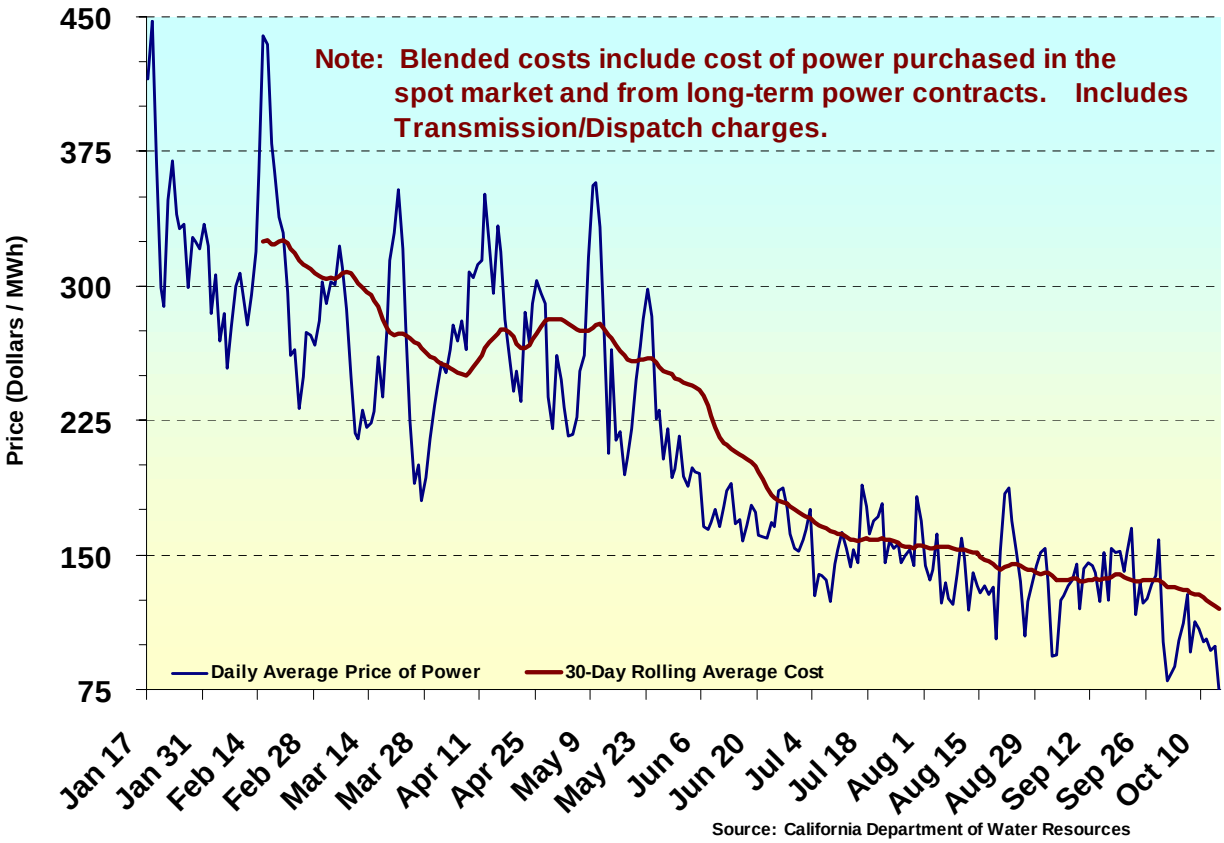
Attachments

DWR Exposure In the Spot Market

Comparison of Spot to Contract Power (2001)



Price of Power Provided by DWR Since January 17, 2001



Source: California Department of Water Resources

ISO Staged Emergencies
(No Staged Emergencies since July 3rd)